THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ESE - Q3 2019 ESCO Technologies Inc Earnings Call

EVENT DATE/TIME: AUGUST 08, 2019 / 9:00PM GMT

CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

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

Robert McCarthy *Stephens - Analyst*

PRESENTATION

Operator

Good day, and welcome to the ESCO Technologies Q3 2019 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*

Thank you. Statements made during this call regarding the amounts and timing of 2019 and beyond, EPS, adjusted EPS, EBITDA, adjusted EBITDA, cash flow, debt, growth, profitability, sales, costs, competitiveness, efficiency, productivity, tax rates, 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 their most comparable GAAP measures can be found in the press release issued today and found on the company's website at www.escotechnologies.com under the link Investor Relations. Now I'll turn the call over to Vic.

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

Thanks, Kate, and good afternoon. As noted in the release, and as Gary will describe in more detail, we wrapped up a strong third quarter by delivering solid top line growth, coupled with over 9% growth in our adjusted EBITDA and 11% growth in our adjusted EPS, exceeding our previous expectations. Additionally, I'm pleased with both our year-to-date entered orders and how the year-to-date order growth was spread nicely across all of our operating segments, which reflects an increase in our June 30 backlog of $50 million and 13% from the start of the year. Given the strength of our year-to-date operating performance, I'm comfortable that we can deliver our commitments for the balance of the year.

I'll now turn it over to Gary for few detailed financial comments.

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

Thanks, Vic. I'll begin by highlighting that in Q3, just as in the past 5 or 6 quarters, our adjusted EBITDA and adjusted EPS exceeded our expectations and beat the consensus estimates by a fair amount and they also reflected meaningful growth over the comparable quarters of the previous year. This success was accomplished through a combination of meaningful sales growth, a favorable sales mix, rigorous cost management, coupled with solid execution across the company and topped off with solid tax planning strategies. It's very comforting to be at this far ahead of plan at this point in the year as it takes some pressure off of our historically high fourth quarter loading. Given that we are well ahead of plan at June 30 and the fact that we are on target with our full year guidance, this means that our Q4 outlook appears much more balanced compared to prior year, where we set several performance records as we delivered 30% of our yearly sales and 44% of our yearly adjusted EPS in Q4 of 2018. We do not carry that level of extraordinary Q4 weighting this year, which should provide confidence in our ability to deliver this more balanced quarterly profile and to end the year with solid growth on all financial metrics in fiscal '19 when compared to '18. Additionally, I think the strength of our results continues to demonstrate the earnings power that we can generate at higher sales volumes and continues to support our multi-segment, multi-industry strategy.

Now I'll touch on a few financial highlights from Q3 and year-to-date. Since the results of both years presented were impacted by several unique non-operating items that we called out in previous releases, I will focus my remarks on the adjusted numbers as these are more relevant measures of our operating performance when compared to expectations and the prior year. Using these adjusted numbers is also consistent with our previous financial statement presentations and related commentary.

We reported Q3 adjusted EPS of $0.81 a share, which is above the top of our guidance range of $0.75 to $0.80 a share, is well above the consensus estimate of $0.77 a share and is $0.08 or 11% above Q3 '18's adjusted EPS of $0.73 a share. Our Q3 adjusted EBITDA increased 9% to $38 million and our year-to-date adjusted EBITDA increased 15% to $100 million. Comparing our year-to-date performance versus '18, we increased sales by 7% lead by Filtration being up 17%. We increased our consolidated gross margin by over a full point. We lowered our SG&A as a percent of sales despite ongoing cost inflation. We lowered our interest costs. We lowered our adjusted income tax rate, all of which contributed to our 32% increase in year-over-year adjusted EPS through June 30.

Repeating my comments from the last call, the percentage increases, we reported in EBITDA and EPS are well above the 7% increase we had in sales, which, again, clearly demonstrates the earnings power we can deliver with solid sales growth. Since the earnings release lays out the key points and highlights of our results, I'll dispense with repeating them here so we can get to the Q&A. So with 7 weeks remaining in the year, I'm confident with our full-year outlook and I believe the risks are well understood. Given the recent acquisition of Globe, we excluded their results from our year's guidance to maintain comparability. And given all the onetime purchase accounting items, which will be recorded in Q4, which we will call out and exclude in our November release, we determined that this was a better course of action. But with that said, Globe is performing to plan. So in closing, coupled with our credit capacity and available liquidity, we are well positioned to effectively execute our M&A strategy and support future growth, both organically and through acquisitions, all while remaining focused on ROIC and increasing shareholder value. And with that, I'll turn it over to Vic.

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

As Gary mentioned, we had a good solid quarter across the company and we're projecting strong finish for the year. Our special projects are on track and on budget as European consolidation of the packaging business is essentially complete and will provide cost savings and productivity enhancements in 2020. We're on schedule at Doble to move into the new facility in the first quarter. Again, this relocation of all our Boston-area employees into one location will enhance collaboration and productivity. Also within USG, we had our first significant order for NRG's bat deterrent product this quarter. And given the strong support from our stakeholders and the positive results, we see this is a growing opportunity for the company. As we previously discussed, we closed the Globe acquisition earlier this quarter and I'm really excited by the addition of Globe to our business. The fit with us is obvious, highly engineered, differentiated products serving niche markets with a high degree of predictable revenue for years to come. Having spent time with the management team and seeing employees in action, I'm confident they will quickly become an integral part of ESCO. We did have an opportunity to meet with their major customers, as well as the end user of their products. And from these meetings, I can say that everyone appears very comfortable and supportive of the change in ownership to a larger company.

Lastly, the integration is well underway and going smoothly. We continue to look for additional acquisitions to support our organic growth and we think we need to execute in both of these areas to support our longer-term growth initiatives.

In closing, we're focused on successfully executing on the fourth quarter and we're planning for successful 2020. I'll now be glad to take any questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Jon Tanwanteng with CJS Securities.

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

Can I ask were there any push outs in the test segment this quarter? That was a little bit lower year-over-year. Did you see any lumpiness there and kind of what are we expecting there in Q4?

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

Yes. The issue is, we did have a little push out there and it is primarily related to some of the site preparation in China. So we were able to cover a lot of that with the domestic business, we're performing very well. We don't think there's any issue here other than just site preparation and I did ask the question, I was down there a couple weeks with Gary -- a couple of weeks ago with Gary. We thought that was something other than just normal delays and all the sites are actually Chinese companies trying to get approval for moving into their sites and really it's just kind of a slowdown in the overall approval cycle there. So we don't think it's going to be an issue, but that's what you saw in the third quarter. But we're really happy with their margins they were able to pick their margins up on even with those lower sales.

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

Got it. And Gary, can you quantify how much was the pushed out both from either in earnings or a revenue perspective?

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

I'd say it was about $3 million to $4 million. So we came up short about $2.5 million and we had baked in a little bit of a hedge, so I'd say $3 million is a good estimate on the sales side. And with that, the incremental margins are about 15% or 16%. So I'd call it in, in round terms $400,000 to $500,000 of EBIT move to Q4. And again, with the planning meetings we just had down there we're comfortable with the way the year looks. So it's going to be a strong fourth quarter, but as you recall from last year, we did have a pretty exceptional fourth quarter last year, so it's not something we're stretching for.

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

Okay. Fair enough. It's good to hear the news about the new products getting traction in NRG. What is the, I guess the opportunities for that and compared to kind of the delta that you've seen when you purchase a company. Does it make up for a lot of what you've seen in terms of the slowdown? Or is there a lot more room to go to make up?

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

Yes. It's really hard to quantify just now. We did just introduce the product. It's not going to be on the same level as some of the other products, but we think it's going to really eat into some of the issues that we've had there. And so it really just depends on how quickly they pick up the product. We think the sales in that product will probably be a little more -- they will be more significant next year than they were this year.

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

Okay. Got it. And then what were -- if you could provide them growth trailing EBITDA margins and then what was this growth rate and seasonality look like? And how does that synergize with your existing sub businesses?

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

I'd say, the -- we're not going to have a whole lot of seasonality there, because, again, when you're in the submarine construction business, these are long-term contracts and we're fortunate to have a level of percentage of completion of milestone buildings relative to that. So it's not -- we're not doing delivering $5 million onetime and then you sit on your hands for a quarter or 2. So I'd say the seasonality is not going to be there, but what you're going to see is a growth profile as this -- these new contracts kick-in at full run rate. So the sequential growth next year of Q1 to Q2 to Q3 to Q4 will be higher in the back end from growth, not from seasonality. And then the margins that we said in the press release a month ago, and we issued that is on an EBITDA basis. It's roughly consistent with the Filtration segment in total. So their EBIT is in the high teens and their EBITDA is kind of in that 20%, 21% range. So it will not be an outlier relative to the group as a whole.

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

I'm sorry, I didn't realize. I didn't understand the question personally, but I realized you were talking about Globe. There's no seasonality, I mean, that factory is jam packed and they've got long-term contract there. So we think once it's up at a level that is it can run at, it will run at that level for the foreseeable future.

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

Okay. Got it. So no exceptional synergies to contemplate when it comes to what you're doing is that going to in Westland?

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

So we're still working through that. I'd say -- and they have already met. We had the Globe guys out at Westland recently and we're still trying to figure that out. I think the biggest opportunity we have -- they're in 2 different coasts, so it's not like we can consolidate facilities or anything like that. The only other thing it does do is give us capacity as some of the follow-on contracts, some of the retrofits for some subs become available. It gives us the capacity to make a really strong case we're the right company to do that as well as the new ships that are being built. Additionally, I think having more expertise there. I think there are opportunities out there that we will chase that maybe we wouldn't have been able to historically. Also, now, we're becoming a more major supplier to the submarine market. And as you know, there's a big ramp anticipated in that market and so we think that being 1 or 2 of the suppliers that take account on, it would give us opportunities to participate in the ramp up as well. We will certainly take advantage of the fact that we've got 3 companies now when we have customer visits it gives us an opportunity to talk about VACCO. It gives us an opportunity to talk about the other 2 companies as well. So I think we'll have some opportunity to leverage that as well as leverage in the knowledge of all 3 of those businesses.

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

Okay, great. And then you guys are usually very active in the M&A arena, obviously, that this was a recent closing, is there anything else in the pipe that we should be looking forward to? And how -- what are the opportunities look like out there?

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

We continue to be very active. We're out visiting potential companies, going through the process. And it's as active now as it has been for a while I said. I think, I said the same thing last quarter. It does feel like there are good opportunities out there, and we're being as aggressive as -- and it's appropriate in pursuing those.

Operator

(Operator Instructions) Our next question comes from Robert McCarthy with Stephens.

Robert McCarthy - *Stephens - Analyst*

Well, congratulations on a solid quarter. I guess, in terms of looking through the various segments, could you talk about kind of your order trends as you're exiting the quarter. And did you see anything, obviously, you have a fairly long cycle (inaudible) your businesses. But did you see anything in the industrial side or more customer facing where you saw any incremental weakness or cyclicality? And comment on order trends as an exit rate coming out of the quarter?

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

Yes. I think -- let me point out one thing, Rob, and I think everybody is aware of this, as the revenue ramps up in the back half of the year, even though we're not as steep as we were last year for Q4, the order dollars are continuing to remain very robust and on track. So we're really not seeing any softness there. The book-to-bill is less than 1 in Q3, but that's really a function of the sales strength as you're burning off some of that backlog. And as we go into Q4, we see very solid dollar growth in the orders, but we see solid sales growth. So we anticipate another book-to-bill less than 1 in Q4, but incrementally dollars would be stronger. So where the real strength is coming from those is as this navy business continues to let the new contracts whether it's for wrapping up Lot 4 on the Virginia Class or the incremental pieces that are coming in Lot 5. The submarine business is really strong for us from an order perspective. The aerospace business remains very robust. It really doesn't have cyclicality, just kind of incrementally moves forward. So we're really happy with what we're seeing in the Filtration side. On the packaging side, obviously, it's seasonality in Q4. It's always their strongest, so you'll see a continued trend there. So we're not going to see any softness in the next 7 weeks or the fourth quarter in total. The test business continues to surprise us with greater than -- a book-to-bill greater than 1, even though their sales are going up. We're really pleased with and I'll let Vic go into the different market dynamics of 5G and stuff like that for some qualitative color around that. And then the utility business. Excluding the softness that we see in the renewable space, it's holding its own in the renewable side in the Doble business or what I call the normal electricity market continues to be really strong, led by a lot of compliance things, whether it's cybersecurity or just kind of meeting and greeting some of these protection suite things that we see every day. So that's kind of the number story and I'd let Vic add some color to the specific markets there.

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

Yes, the fact, we're up $50 million in backlog since the start of the year is pretty positive. Pretty positive, and as Gary said, I think the key is, we're where we thought we want to be. And so there hasn't been any areas really of softness. I mean, I think there's always project to the project there, but then we get some that, maybe we hadn't expected. So I think from an order perspective, we've not seen anything that really concerned us.

Robert McCarthy - *Stephens - Analyst*

Yes. In terms of USG, I mean, could you just comment around some of the differences there? I mean, obviously, it looks like Doble had a very good quarter and you have heard from some other, not comps, but peers, I suppose, better strength at the T&D side in terms of base spending, and obviously, awareness has only increased with the focus on the Smart Grid technology as a whole, but also the awareness around the recent blackouts. So -- and then could you just comment on what's really driving the weakness on the NRG side? And when you expect that's kind of bottom out?

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

Sure. So I think Doble will continue to perform well. There's always a lot of interest in a key supplier at all of these utilities and so when there is an issue like at ConEd, who is a big customer of ours and they do look to us for help then to understand what happened, what they can do to change that. The NRG side really is a couple of things. As we've mentioned before, tax reform had an impact on them because the grandfather -- the tax credit is coming to an end. The grandfather projects are already up and running, and so really, a lot of the big developers have focused more on completing projects that they already had started. And so they aren't working as many of the new projects as they were historically. I think once we get through this, some of this spills out that will pick back up. The other thing that impact us -- impacted us a bit, it was China. China has softened up. It is a combination of -- they're not building quite as many as they were before because they -- a lot of the systems they have aren't even connected to the grid yet. So they are -- they're slowed down a little bit and honestly, they're trying to knock off some of our products and so we've been fighting though that a little bit. Exactly when it's going to turnaround, we're not positive. It's one of those things where we're close to the customers, but it's hard to tell when you're actually going to pick back up, I'll be up there in a couple of weeks and spend some time with those guys and I hope to get a little better perspective not that I'm not talking to them, but it's always better face-to-face, but this is not a long-term issue I don't believe, the renewable space is going to be solid and it's the future, people are going to continue to invest here. And so we're just hit a little bit of soft spot here, and fortunately some of the other business have been stronger to be able to cover for that.

Robert McCarthy - *Stephens - Analyst*

Yes. In terms of your appetite for M&A, it seems like clearly on the filtration side particularly, defense or navy as the case may be where you have real strength. And the USG would presumably be more on the Doble side of the house than anything else. Could you comment on just the size of properties you're seeing and kind of the valuations you're seeing and whether you think this is still something you can kind of continue to transact here and is there an opportunity wherever we are in the cycle to perhaps even do something a little larger in one of those key verticals?

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

I'd say the valuations are all over the board and it really depends on whether we go to an auction or not. I mean, there was transaction recently in the aerospace side, which was just a ridiculously, in my opinion, obviously, somebody paid it, but a multiple of that -- it was well above where we would participate. On the other hand, if we're able to get in there before, while we have a seller that is really interested in being partner strategic, we have been able to get those in much more reasonable multiples. So it's -- overall, I would say that the market still is a little frothy, but it sort of takes a little more work to go find the properties you get for a reasonable value, but I think we've demonstrated the ability to be able to do that. On the utility side, we've had a lot of success in buying the smaller businesses, dropped them in to Doble's distribution networks and really enhancing the growth of the business as well as the profitability. Sure, I would love to buy a little bit bigger, but we're not going to go do something stupid, but any smaller deals are complicated as larger ones are, and so the businesses that our $50 million to $100 million in sales will be very attractive to us at a reasonable multiple.

Robert McCarthy - *Stephens - Analyst*

Could you expand upon that, I might have missed that. Did -- have you shared with The Street the expected accretion from the most recent naval acquisition going forward over the next 12 months once we get kind of through inventory step up and some other issues? And then what is the state of your balance sheet in terms of -- what is your out of bound of comfort for doing a deal in terms of size?

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

Yes. I'll take part of that and then I'll let Vic address the strategic part of the comfort with the balance sheet. So I'll give you the numbers on that Rob. So when we put the release out in early July and we calibrated the revenue and it stands today at about $37 million in the just used 20% because I can do that even in my head with my calculator of EBITDA. So you're kind of getting yourself into that $8 million or $9 million, kind of, range there. So obviously, you have taxes against that. And you have some interest. So the accretion is going to be -- it's positive. It's not a rounding error. It's not $0.50, obviously, but it's very attractive and then it grows from that because the contracts that we have in place in the submarine volumes that are increasing in the content that Globe has and expects to have in the future. It will have a meaningful growth prospects. So it's not -- we're not going to have to explain in a year from now what we paid for and so that's really good. So hopefully that leads you back into an EPS accretion number on that side. And then on the other side when we look at what the balance sheet looks like, we levered at the state that we just issued in it. It's about 1.5 and to pro forma, with what we paid for Globe, had we purchased Globe before the quarter end, it would have been right at 2.0. So that's not really stretching us on a leverage ratio perspective. And then as you know, in the fourth quarter, that's always our strongest cash generation. So if we didn't buy anything in the next 7 weeks, we should wrap the year up somewhere in the neighborhood of about 1.5 -- I'm sorry, 1.85 of a leverage ratio, which in dollars against our credit facility gives us a tremendous amount of dry powder. So that's the math and I'll turn it over to Vic for what the comfort zone is on spending in leverage ratios.

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

Yes. What we've consistently said -- both Gary and I said, probably the outer limit for us is like 3.5x, certainly you go above that and if it was something where we really needed to have it, I should say needed to have -- really wanted to have it and there was a clear path to quickly delever from that then, obviously, we'd be -- we'd have to look at stretching a bit. But as far as the size, it really would -- is very property dependent. And if something comes up, it's a little larger than that then we'd had to look at alternatives, but we wouldn't want to pass on something if it was an absolute perfect fit. Unfortunately, we've not ran into that problem yet, but I think we are in a position where if something like that presents itself, we can react.

Robert McCarthy - *Stephens - Analyst*

Yes. And then the final question for me is just on the cash generation. Obviously, definitely an area where you would like to improve more. Obviously, fourth quarter a better harvesting period for you for cash generation as a whole. Where -- what you -- how would grade your performance in this quarter and what are you looking for to kind of improve the underlying free cash flow as they give conversion as we kind of look into the out years?

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

Yes. I'd say on the grading as the finance guy. I put it as a C or a C- because we came up a little short in a couple of places. We understand where it's at, but no it's not certainly something we're beating the drum on. But it's really isolated to a couple of things. Relative to these navy programs, we hit milestones that recognize the revenue. The sequence or the cadence of when you get paid for that is normally, generally pretty quick, but in some cases, it goes up 45 to 60 days. So if you look it back on Westland as a particular center point of that softness, it's really a timing issue relative to when the government comes out and improves the product and does all the milestone approval and all that. So I put that as a C because of timing. And so carrying that into what the fourth quarter expectations are, we're looking at about 100% improvement in Q4 because those things that we talked about that didn't come in June, have come in, in July. So we're off to a roaring start in Q4. So the outlook for Q4 is cash generation. That's what I'd like to year to look like, if I took that quarter and annualized it. So we have a couple of things in place like when you and I've talked before Rob, we're not happy with the way it is. We want to get our cash conversion from a relationship of net earnings to cash somewhere in the upper 80s to low 90s and I think we're in the mid-70s to upper 70s. So we have a lot of low-hanging fruit there. And so we have some internal resources being devoted to that. So I'd say a C for the quarter. I'd put us at a B- year-to-date. And I think when we finish the year with the strength of Q4, it will be a really solid B to B+ with room for improvement.

Operator

And I'm not showing any further questions at this time. I would now like to turn the call back over to Vic Richey for any closing remarks.

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

Okay. Thanks to everyone and we look forward to talking to you on the next call.

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

Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program and you may all disconnect. Everyone, have a wonderful day.
